FILED
03 776 NOV 20 2003
OFFICE OF THE CLERK

No. 03-___

In The

Supreme Court of the United States

FRANCHISE TAX BOARD,

Petitioner,

v.

FARMER BROS. CO.,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The Second Appellate District

PETITION FOR A WRIT OF CERTIORARI

JOHN W. DAVIES, Chief Counsel
BENJAMIN F. MILLER, Counsel, Multistate Tax Affairs
(*Counsel of Record*)
KARL W. GROSSENBACHER, Sup. Tax Counsel
CRAIG A. SWIESO, Tax Counsel
CALIFORNIA FRANCHISE TAX BOARD
Post Office Box 1720
Rancho Cordova, CA 95741-1720
(916) 845-3320 Fax: (916) 845-3648

Attorneys for Petitioner
California Franchise Tax Board

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

64 pp

QUESTION PRESENTED FOR REVIEW

Section 24402 of the California Revenue and Taxation Code relieves California's double taxation of California corporate income by allowing corporations to deduct dividends received when the income from which the dividends were paid was previously taxed by California. The question presented is whether a deduction, granted to relieve a burden that only intrastate commerce bears, discriminates against interstate commerce in violation of the dormant Commerce Clause?

PARTIES TO THE PROCEEDING

The parties to the proceeding are:

FRANCHISE TAX BOARD, an agency of the State of California charged with the administration of the California Corporation Tax Law, sections 23001-25141, of the California Revenue and Taxation Code.

FARMER BROS. CO., a publicly-traded California corporation. Petitioner is unaware of any parent company or nonwholly-owned subsidiaries of respondent.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED FOR REVIEW	i
PARTIES TO THE PROCEEDING	ii
PRAYER	1
OPINIONS BELOW	1
BASIS FOR SUPREME COURT JURISDICTION	1
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	2
REASONS FOR GRANTING WRIT	6
A. Whether the Dormant Commerce Clause Requires a State to Extend a Deduction to Interstate Commerce, Because It Grants a Deduction Tailored to Relieve a Burden Borne Only by Intrastate Commerce, Is an Important Question Involving Our System of Federalism and the Legislative Options of the States to Relieve Burdens on Intrastate Commerce	6
B. The States Need Direction as to the Permissible Contours of a Compensatory Tax	13
1. The Compensatory Tax Defense	13
2. The Decisions of This Court Have Not Addressed the Question of Whether the Compensatory Tax Defense Has Application When a Single Levy Is Involved	15

TABLE OF CONTENTS – Continued

Page

3. This Court Has Not Answered the Question of Whether a Tax on a Corporation Is Sufficiently Equivalent to a Tax on the Dividend Income Received by Shareholders of the Corporation to Satisfy the Requirements of the Compensatory Tax Defense 16

4. Errors in the California Court of Appeal's Analysis 17

5. The California Dividends-Received Deduction Meets the Requirements of the Compensatory Tax Defense When It Is Correctly Applied 21

CONCLUSION 23

TABLE OF AUTHORITIES

Page

CASES

Associated Indus. of Mo. v. Lohman, 511 U.S. 641 (1994) 6

Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994) 7

Butler Bros. v. McColgan, 315 U.S. 501 (1941) 7

Camps Newfound/Owatonna v. Town of Harrison, 520 U.S. 564 (1997) 14

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) 6

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983) 7, 11

D.D.I. Inc. v. State, 657 N.W. 2d 228 (N.D. 2003) 13

Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) ..... *passim*

Goldberg v. Sweet, 488 U.S. 252 (1989) 12

Henneford v. Silas Mason Co., 300 U.S. 577 (1937) 6, 15

Maryland v. Louisiana, 451 U.S. 725 (1981) 15

Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980) 7, 11

Oregon Waste Systems, Inc. v. Dep't of Environmental Quality of Or., 511 U.S. 93 (1994) ..... *passim*

Rosemary Properties v. McColgan, 29 Cal. 2d 677 at 688-89 (1947) 9

Safeway Stores, Inc. v. Franchise Tax Bd., 3 Cal. 3d 745 (1970) 9

Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987) 15

Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) 7

TABLE OF AUTHORITIES – Continued

Page

CONSTITUTIONAL AND STATUTORY PROVISIONS

U.S. Const. art. 1, § 8, cl. 1 and 3 2

26 U.S.C. § 61(a)(7) 8

26 U.S.C. § 243 8

28 U.S.C. § 1257(a) 1

28 U.S.C. § 2101(c) 1

California Rev. & Tax. Code § 23001 2

California Rev. & Tax. Code § 23151 9

California Rev. & Tax. Code §§ 24271, 24401 and 24402 ..... *passim*

California Rev. and Tax. Code §§ 25120-25141 7

OTHER AUTHORITIES

W. Hellerstein, "*Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*," 39 Tax Lawyer 405 (1986) 22

PRAYER

The California Franchise Tax Board ("FTB") respectfully petitions that a Writ of Certiorari be issued to the Court of Appeal of the State of California (Second Appellate District, Division One) in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal below (App. A, *infra*) is reported at 108 Cal. App. 4th 976 (Second Appellate District, Division One, May 21, 2003).

BASIS FOR SUPREME COURT JURISDICTION

The Court of Appeal of the State of California, Second Appellate District, Division One, entered its decision on May 21, 2003. Petitioner, the California Franchise Tax Board, seeks review of that decision on a writ of certiorari.

On July 1, 2003, the California Franchise Tax Board filed a timely Petition for Review with the California Supreme Court. On August 27, 2003, the California Supreme Court filed an order denying the Petition for Review (App. D, *infra*). The present petition is timely filed under 28 U.S.C. § 2101(c) and Rule 13.3 of this Court.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. 1, § 8, cl. 1 and 3, provides:

> The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Pertinent portions of the California taxing statutes (California Rev. & Tax. Code §§ 24271, 24401 and 24402) appear in Appendix F.

STATEMENT OF THE CASE

For the years 1992 through 1998, Farmer Bros. Co. ("Taxpayer") filed California corporate income tax returns claiming a "dividends-received deduction" under section 24402 of California's Revenue and Taxation Code.[1] That section provides corporations with a deduction[2] for dividends received that are declared from "income which has been included in the measure of the taxes imposed" under the California Corporation Tax.[3] Section 24402 has been

[1] Unless otherwise indicated, all "section" references refer to sections of California's Rev. & Tax. Code.

[2] The deduction is allowed in varying portions (percentages) depending upon the percentage of ownership the dividend-recipient corporation has in the dividend-paying corporation. This limitation is not at issue in this case and is therefore ignored for purposes of the Petition.

[3] California Rev. & Tax. Code § 23001 and following.

an integral part of the Revenue and Taxation Code from the date the Corporation Tax was enacted in 1929.[4]

On its originally-filed returns, Taxpayer limited its section 24402 deduction, as required by that section, to the dividends that it received from corporations whose income had already been subjected to tax by California. Taxpayer subsequently filed amended tax returns (i.e., claims for tax refund) claiming that section 24402's limitation upon the dividends-received deduction to dividends attributable to income that already had been subjected to the California Corporation Tax was unconstitutional under the Commerce Clause of the United States Constitution because it discriminated against interstate commerce. Therefore, Taxpayer claimed it was entitled to a deduction under section 24402 with respect to *all* of the dividends it received.

Taxpayer exhausted its administrative remedies and commenced a tax refund suit in the Superior Court of the County of Los Angeles, California. In its complaint, Taxpayer alleged that section 24402 was unconstitutional because it discriminated against interstate commerce in violation of the Commerce Clause of the United States Constitution by granting a deduction only with respect to dividends that were paid from income previously subject to California tax.[5] The Franchise Tax Board ("FTB") filed an

---

[4] It then appeared as section 8(h), Ch. 13, Stats 1929, p. 23.

[5] Taxpayer's initial and amended complaints also included allegations of violations of other provisions of both the California and United States Constitutions, all of which were stricken by the trial court early in the proceedings on motion of the Franchise Tax Board.

answer, denying that the deduction resulted in discrimination against interstate commerce and alleging that in the event the deduction was found to be facially discriminatory, it nevertheless met the requirements of this Court's "compensatory tax defense" and therefore should be sustained against Taxpayer's constitutional challenge.

The matter came to trial on October 25, 2001, at which time the parties filed opening trial briefs, a joint stipulation of agreed facts, and interrogatories propounded by the Taxpayer and FTB's response to those interrogatories. FTB proffered a witness list of two professors, one an economist and one an expert in tax policy, who would testify to presence of the factual predicates of the compensatory tax defense. Taxpayer filed a motion *in limine* to bar the testimony of the proffered witnesses. The parties agreed to bifurcation of the trial. The trial court was first to consider and rule upon the Commerce Clause issue. If the trial court determined that the statute was constitutionally infirm, a second proceeding would be held to determine the relief to be granted to the Taxpayer.

After reviewing the submitted materials, the trial court, on November 21, 2001, issued its ruling in a minute order, concluding that section 24402 "facially places an unconstitutional burden on interstate commerce" (App. E, *infra*). The trial court denied the Taxpayer's motion *in limine* as moot.

FTB filed an application for an extraordinary writ with the Court of Appeal, arguing that the trial court erred: 1) in finding that section 24402 discriminated against out-of-state interests; 2) in finding that the requirements for a constitutionally permitted compensatory tax were not met; and 3) by failing to deny the Taxpayer's

motion *in limine* on the merits. The application for the writ was denied on March 7, 2002 (App. C, *infra*).

Briefs were filed on the remedy issue. The trial court thereafter ordered that the requested refunds be granted. Judgment was entered on May 13, 2002 (App. B, *infra*).

FTB filed a timely notice of appeal on the Commerce Clause issue. FTB argued: 1) that section 24402 did not discriminate; and 2) that even if section 24402 was facially discriminatory, it was saved by application of this Court's compensatory tax defense.

The trial court's decision (App. B, *infra*) was affirmed by California's Second District Court of Appeal, which held that: 1) section 24402 was facially discriminatory because "it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California," and 2) the disparate treatment provided to previously taxed-in-California income versus previously untaxed-in-California income was not justified as a compensatory tax enactment under the applicable precedents of this Court (*Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (*Fulton*) and *Oregon Waste Systems, Inc. v. Dep't of Environmental Quality of Or.*, 511 U.S. 93 (1994) (*Oregon Waste*)).

FTB timely filed a Petition for Review with the California Supreme Court. On August 27, 2003, the Petition for Review was denied by the California Supreme Court without comment (App. D, *infra*).

REASONS FOR GRANTING WRIT

A. Whether the Dormant Commerce Clause Requires a State to Extend a Deduction to Interstate Commerce, Because It Grants a Deduction Tailored to Relieve a Burden Borne Only by Intrastate Commerce, Is an Important Question Involving Our System of Federalism and the Legislative Options of the States to Relieve Burdens on Intrastate Commerce.

The decisions of this Court have long held that the dormant Commerce Clause prohibits a State from legislating in a manner that gives an advantage to intrastate commerce over interstate commerce. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). This Court has also made clear that the dormant Commerce Clause is not violated if state legislation treats intrastate and interstate commerce equivalently. *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994); *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937). There are no decisions of this Court, however, holding that the dormant Commerce Clause requires a State to *disadvantage* intrastate commerce as compared to interstate commerce by requiring intrastate commerce to bear a burden that interstate commerce does not. That is the question that this case presents, and it is one that this Court should answer to define permissible legislative action.

California has exercised its right to tax corporate income that is fairly and properly attributable to California in a manner consistent with the constraints established by the United States Constitution (specifically the Due Process Clause of the Fourteenth Amendment and the Commerce Clause). This Court has approved California's application of the unitary business principle, including the

use of combined reporting and the business-nonbusiness characterization of income pursuant to the Uniform Division of Income for Tax Purposes Act,[6] to assess corporate franchise and income taxes. *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Butler Bros. v. McColgan*, 315 U.S. 501 (1941). Under this approach, California may consider the activities of a unitary business, and the income generated by those activities, that occur without its borders, but California *only* taxes the income that is properly attributed to California.

California exercises its right to include dividends in the corporate income base subject to tax.[7] California, however, also has recognized that by requiring dividends to be included in the corporate tax base, it has created double (or even multiple) taxation of such income at the corporate level *when* the dividends are paid from income that was previously taxed by California in the hands of the dividend-paying corporation.[8] The income is first taxed

---

[6] Sections 25120-25141, California Rev. & Tax. Code.

[7] Section 24271, California Rev. & Tax. Code. The right of a State to consider and tax dividend income, regardless of the relationship of the dividend-paying corporation to the State, has long been recognized by this Court. *E.g.*, *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980); *Wisconsin v. J.C. Penney Company*, 311 U.S. 435 (1940). Taxpayer does not contest the fact that California can tax the dividends at issue in this case. The taxpayer only claims that if California chooses to forego tax with respect to some dividends (those paid from income that California has previously taxed), California must forego taxing *all* dividends.

[8] As the phrases are used herein, "double taxation" or "multiple taxation" refers to the taxation of the income of a corporation followed by taxation of the same income when it is paid by that corporation as a dividend to a shareholder corporation and taxed again in the hands of that shareholder corporation.

when the dividend-paying corporation earns income from its business operations attributable to California. The California income, but for section 24402, would be subject to tax a second time (and potentially multiple times after that) when it is distributed as a dividend to a corporation that is a California taxpayer. The practice of taxing dividends, despite the double taxation of income at the corporate level when the dividend is received by another corporation, is a well-established practice under both State and federal law (see 26 U.S.C. § 61(a)(7), incorporated by reference by California under section 24271). Such taxation does not give rise to constitutional concerns.

Nevertheless, both the federal government and California have chosen, as a matter of *tax policy*, to reduce the double corporate tax burden imposed in such situations. At the federal level, Congress has provided limited relief from the double corporate taxation of dividends by the dividends-received deduction of 26 U.S.C. § 243; at the state level, California has provided comparable limited relief by the dividends-received deduction of section 24402. The operation of the two statutes is similar. Both statutes, in general, grant relief to corporate shareholders only as to dividends received from corporations whose earnings *already have been subject to tax by the taxing jurisdiction.* The federal dividends-received deduction permits a dividend recipient to deduct a portion of the dividends received "from a domestic corporation which is subject to taxation under this chapter." 26 U.S.C. § 243(a). The corresponding California provision, section 24402, provides relief with respect to "dividends received . . . from income which has been included in the measure of the taxes imposed" upon the taxpayer declaring the dividends.

It was in furtherance of these well-established tax principles that California, in 1929, adopted the predecessor to section 24402 when it first enacted its Corporation Tax. As recognized by the California Supreme Court, "The purpose of [the dividends-received deduction] is to avoid double taxation at the corporate level of income which has already been subject to California taxation in the hands of the dividend-declaring corporation." *Safeway Stores, Inc. v. Franchise Tax Bd.*, 3 Cal. 3d 745, 750 (1970); *Rosemary Properties v. McColgan*, 29 Cal. 2d 677 at 688-89 (1947) (Traynor, dissent).

The operation of the deduction is illustrated by the following simplified[9] examples:

1) A dividend-payor, Corporation A, earned $100 that was taxed by California. Its California tax on this income is $8.84 ($100 multiplied by the current statutory rate of 8.84%).[10] Corporation A pays a dividend of the after-tax income, $91.16 ($100-$8.84), to Corporation B. Corporation B receives $91.16 of income. But for section 24402, Corporation B would pay a tax of $8.06 on the receipt of the dividend ($91.16 of income multiplied by the statutory rate of 8.84%). However, section 24402 allows Corporation

[9] The examples were constructed without taking into account either the percentage limitation related to ownership or that the income of both the dividend-paying and dividend-receiving corporation may be determined on an apportioned basis so that something less than 100% of their incomes would be taxed by California. These facts would add unnecessary complexity to the examples but would not change the essential relationships.

[10] Section 23151, California Rev. & Tax. Code.

B to take a deduction of $91.16 with respect to the dividend. Because of the deduction, Corporation B pays no California tax on the dividend. California receives a total tax of $8.84 on the $100 of income earned by Corporation A and paid to Corporation B.

2) A dividend-payor, Corporation C, earned $100 that is not taxed by California. A dividend is paid of the after-tax income, $100.00, to Corporation D. Corporation D receives $100.00, which is taxed by California at the statutory rate of 8.84%, and pays California a tax of $8.84. Corporation D does not receive a deduction under section 24402 because the income from which the dividend was paid was not previously taxed by California. Corporation D has after-tax income of $91.16. California receives a total tax of $8.84 on the $100 of income earned by Corporation C and paid to Corporation D.

As these two examples illustrate, California, because of section 24402, has asserted a single tax of $8.84 on the same $100 of income. The after-tax income of the dividend recipient is the same in both circumstances, $91.16. But for section 24402, in example 1 California would receive a total tax of $16.90 on the $100 of income earned by Corporation A and paid to Corporation B, and Corporation B would have after-tax income of only $83.10. California, by allowing a dividends-received deduction, has avoided taxing this income twice. To the extent that California has not taxed the income of the dividend-paying corporation because it is sourced outside of California, there is no California double taxation; therefore, there is no burden on interstate commerce created by California, and no need to provide relief. In example 2 above, if California were to

extend the dividends-received deduction to *all* dividend income regardless of whether California had previously taxed the income from which the dividend was paid, as required by the ruling of the California Court of Appeals below, the corporate recipient of the dividend would have $100 of after-tax income attributable to California and California would receive no tax. In contrast, as illustrated in example 1, intrastate commerce would have paid a tax of $8.84 if no dividend deduction were allowed with respect to income that California has not previously taxed. Discrimination against intrastate commerce would be the result.

The decision of the California Court of Appeal that section 24402 discriminates against interstate commerce is without any logical foundation or judicial support because that section creates no burden on interstate commerce. California can only tax California income; it does not tax income attributable to other states. The taxation of dividend income at the corporate level gives rise to the burden of California double taxation only when California has previously taxed that income.[11] If a dividend received by a California corporate taxpayer is paid from income that has not been taxed by California, there is no California double-taxation burden to relieve.

The inequity created by the holding below is compounded because, not only is there no discrimination

---

[11] Under this Court's decisions and the Due Process Clause of the Fourteenth Amendment, California can, and does, tax only California income. *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980); *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

against interstate commerce, but the denial of the deduction actively *creates* discrimination against California intrastate commerce. Without the section 24402 deduction, California taxes the same intrastate income twice. It is one thing to hold that the Commerce Clause does not protect intrastate commerce from discrimination, *Goldberg v. Sweet*, 488 U.S. 252 (1989), but it is a far different, and novel, proposition to hold that the Commerce Clause *affirmatively requires* such discrimination.

The holding of the California Court of Appeal has broad and important implications for state tax policy and our federalism. In the context of laws that apply both to interstate and intrastate commerce, if States cannot act to remove, or limit, the burdens on intrastate commerce that they have created, intrastate commerce will not be on an equal footing with interstate commerce.[12] States will be hamstrung in their efforts to ensure that intrastate and interstate commerce each pays its fair share, and no more than its fair share, of the cost of an ordered society. The decisions of this Court applying the Commerce Clause to State taxes and State tax deductions do not require the result reached by the Court below. Only this Court can provide the necessary guidance with respect to its Commerce Clause decisions to correct the problem that can be caused by the decision of the California Court of Appeal.

---

[12] For example, most, if not all, States asserting a tax on or measured by income grant credits against those taxes. State corporate income taxes are determined by considering in-state and out-of-state activities (interstate commerce) in determining the in-state income. The credits, however, are allowed only with respect to intrastate activities.

B. The States Need Direction as to the Permissible Contours of a Compensatory Tax.

This case presents several questions that this Court has not previously addressed. The States need answers with respect to those questions. The California Court of Appeal has misapplied the decisions of this Court to find that California's dividends-received deduction does not meet the requirements of the compensatory tax defense. The Supreme Court of North Dakota also reached the same result with respect to a similar deduction granted by that state.[13] These erroneous decisions demonstrate the need for this Court's direction.

1. The Compensatory Tax Defense

This Court has held that a facially discriminatory[14] State tax is "virtually *per se*" invalid under the Commerce Clause. However, this Court's decisions also have held that a facially discriminatory tax is constitutional if it meets the requirements of the compensatory tax defense. *Fulton,, supra*, 516 U.S. at p. 331.[15] This Court has never held

---

[13] *D.D.I., Inc. v. State*, 657 N.W. 2d 228 (N.D. 2003).

[14] This Court has not specifically defined what a facially discriminatory State tax is, but it appears that a State tax that gives rise to differential tax treatment, based upon geographic (state and national) considerations, is facially discriminatory for dormant Commerce Clause analysis purposes. Section 24402 provides differential treatment based upon whether the income from which a dividend was paid was, or was not, previously included in the measure of the California Corporate tax. Under this definition, section 24402 is a facially discriminatory tax.

[15] This Court has *not* indicated that the compensatory tax defense is the only defense available to save a tax from a claim of facial discrimination. For example, in addition to showing that a tax does not have a discriminatory effect, this Court has stated that a

(Continued on following page)

that a State statute that satisfies the requirements of the compensatory tax defense is invalid.

This Court has set forth the following three-prong test to determine the applicability of the compensatory tax defense:

> (1) "[A] State that invokes the compensatory tax defense must identify the intrastate tax for which it seeks to compensate. . . ." *Fulton*, *supra*, 516 U.S. at p. 334;
>
> (2) "[T]he tax on interstate commerce [must] be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce." *Id.*, at p. 336; and
>
> (3) "The compensating tax must fall on 'substantially equivalent events' to the tax for which it seeks to compensate." *Id.*, at p. 338.

Under that test, a tax (or tax deduction[16]) constitutes a valid compensatory tax enactment *despite* its apparent facial discrimination if it meets all three prongs of the test.

---

discriminatory tax can be saved if the State can show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564 (1997). The deduction at issue advances a legitimate local purpose, relief from double taxation, which cannot be achieved by a reasonable nondiscriminatory alternative.

[16] "That the tax discrimination comes in the form of a deprivation of a generally available tax benefit, rather than a specific penalty on the activity itself is of no moment." *Camps Newfound/Owatonna*, *supra*, 520 U.S. at pp. 578-579.

2. The Decisions of This Court Have Not Addressed the Question of Whether the Compensatory Tax Defense Has Application When a Single Levy Is Involved.

The compensatory tax defense is an analytical tool used by this Court to determine whether a facially discriminatory tax does not discriminate in fact. The prototypical application of the compensatory tax defense, or complementary tax defense,[17] is with respect to State sales and use taxes. *Henneford v. Silas Mason Co.,* 300 U.S. 577 (1937). Two different taxes were involved in *Silas Mason.* The States have unsuccessfully asserted the defense in other circumstances involving two different taxes. *E.g., Oregon Waste, supra* (the earning of income paired with the disposing of waste); *Fulton, supra* (a tax on intangibles paired with the earning of income); *Maryland v. Louisiana,* 451 U.S. 725 (1981) (a tax on the severance of natural resources paired with tax on the use of the resources); *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue,* 483 U.S. 232 (1987) (manufacturing and wholesaling of tangible goods).

This Court has not had occasion to consider whether the compensatory tax may be applicable in the context of a single tax. There is no reason, however, why it should not. The logic of the compensatory tax defense is equally applicable in the circumstance of a single tax as it is when there are two taxes involved. This case presents the opportunity for this Court to address the question of

---

[17] "We use the terms 'compensatory' tax and 'complementary' tax as two ways of describing the same phenomenon. . . . " *Fulton, supra,* 516 U.S. at p. 331, n2.

whether the compensatory tax defense is applicable in the circumstance of a single tax.

3. This Court Has Not Answered the Question of Whether a Tax on a Corporation Is Sufficiently Equivalent to a Tax on the Dividend Income Received by Shareholders of the Corporation to Satisfy the Requirements of the Compensatory Tax Defense.

A single tax, the California Corporation Tax, is at issue in this case. The same event, the earning of income (once as operating income and again as a dividend), is being taxed in the hands of both taxpayers. The amount of income the first taxpayer earns directly impacts upon the amount of dividends it can pay to the second taxpayer. Relief is granted to one taxpayer, the dividend-recipient corporation, because a tax has been imposed upon another taxpayer, the dividend-paying corporation. The California Court of Appeal held that the fact that two taxpayers were involved meant that the substantial equivalency prong of the compensatory tax defense was not met.

This Court has left the question of whether complementary taxes may be imposed on differently described taxpayers unanswered. The opportunity to consider this question was presented in *Fulton,* but it was not addressed. It was not addressed because of the number of other variables that were present that defeated the State's efforts to make a compensatory tax defense. The Court, however, recognized the existence of this question ("In principle, the door may be open for such an argument."

Fulton, supra, 516 U.S. at p. 341.) The policy reason for granting a dividends-received deduction is to relieve double taxation of the same income.[18] Under this justification, the fact there are two different taxpayers should not prevent the successful application of the compensatory tax defense. Because this case involves the single variable of two different taxpayers, this is the case in which that argument must be addressed.

4. Errors in the California Court of Appeal's Analysis

The California Court of Appeal, after determining that the deduction was facially discriminatory, limited its analysis of section 24402 to the application of the compensatory tax defense. The California Court of Appeal relied on two decisions of this Court, *Fulton* and *Oregon Waste,* where this Court found that the compensatory tax defense was inapplicable.

Fulton involved a property tax on the value of intangibles. In computing the State tax base, a deduction was allowed, based upon the extent to which the income of the issuer of the intangible was subject to income tax by the State. In *Fulton*, there were two separate taxes measured by two different values. The State attempted to establish

[18] To illustrate, if a corporate tax were not imposed on the dividend-paying corporation, its earnings and profits would be larger by the amount of the tax not paid. The resulting increase in earnings and profits could then be used to pay a dividend to the shareholders. Thus, the shareholders' pool of available dividends is exactly reduced by, and thus burdened by, the amount of tax that the corporation it owns was required to pay.

the requisite compensatory relationship between the two taxes by arguing that the funds generated by both taxes were used in regulating the securities industry within the State. This Court dismissed the justification as "unconvincing."[19] *Fulton, supra,* 516 U.S. at p. 335.

Oregon Waste involved a fee assessed for the disposal of waste that was generated outside of the State that was in excess of the fee charged for the disposal of waste generated within the State. The fees were used to fund the disposal of solid waste but were insufficient to meet all of the costs. The State's general revenues, including the income tax, were used to supplement the fees. The State attempted to invoke the compensatory tax defense to justify the higher fee charged out-of-staters on the basis that the out-of-staters were not subject to the State's income tax. The defense failed because there were two different measures for the levies; the fee on the out-of-state entity was calculated on a *per ton* basis, whereas the levy for which it was asserted to be compensating was the State's corporate tax measured by income.

For purposes of the compensatory tax defense analysis, this Court's decisions focus on three critical elements – the taxable event, the measure of the tax, and the tax rate. In the instant case, in contrast to *Fulton* and *Oregon*

---

[19] This Court also commented that its skepticism regarding the justification was "reinforced by the fact that the Secretary did not advance it [the cost of regulating the securities industry] to the state courts." *Fulton, supra,* 516 U.S. at p. 336, n.4. By way of contrast, California's justification for the compensatory tax defense, the relief of double taxation, is not after-the-fact. It has been advanced since 1929 when the deduction was first adopted by California.

Waste, a single tax is levied on the same event, at the same rate, and is used for the same purposes. In other words, this is not a "special tax to general tax" mismatch, but rather an exact match of general tax to general tax that is wholly contained within the same taxing system. This makes the comparisons involved in the compensatory tax defense simple and complete. The fact that a single tax is involved eliminates the complexities that this Court was concerned with in *Fulton* and *Oregon Waste.* The California Court of Appeal's decision does not focus on, and in fact ignores, the critical elements of this Court's analysis.

In analyzing whether the first and second prongs of the compensatory tax defense were met, the California Court of Appeal focused on the fact that the compensating taxes in *Fulton* and *Oregon Waste* were general levies, as is the compensating tax in this case. In spite of noting that this Court has stated that general levies are not necessarily inappropriate for use in the compensatory tax defense,[20] the California Court of Appeal found that the fact the section 24402 deduction occurred within a general levy meant that the necessary comparisons could not be made. The California Court of Appeal misconstrued this Court's comments to mean that a general levy could never be a compensating tax. It did not recognize that this Court's analysis was made in the context of comparing a general levy to a specific-purpose levy. It ignored the fact that the

[20] "While we need not hold that a State may never justify a compensatory tax by an intrastate burden included in a general form of taxation, the linkage *in this case* between the intrastate burden and the benefit shared by out-of-staters is far too tenuous to overcome the risk posed by recognizing a general levy as a complementary twin." *Fulton, supra,* 516 U.S. at p. 336 (emphasis added).

comparison in the case before it was occurring within a single tax system and therefore an identical levy was involved.

In applying this Court's precedents, the California Court of Appeal focused on the use of the proceeds of the levy. The California Court of Appeal interpreted this Court's decisions as meaning that a general revenue measure cannot be used as a compensatory alternative for a specific-purpose levy. Even if the California Court of Appeal's interpretation were correct, it is irrelevant for this case. In this case, a general levy is being used to compensate for the very same general levy.

Finally, the California Court of Appeal held that the income events at issue in section 24402 were not substantially equivalent by comparing them to *Fulton* and *Oregon Waste*. However, the facts in those cases are not comparable to the facts in this case. In *Fulton,* the events being taxed were the value of capital stock and the earning of income. In *Oregon Waste,* the events were the disposal of trash and the earning of income. In both cases, the events were of different types and the claim of substantial equivalency therefore was rejected. In the instant case, the incidence of tax with regard to both levies is the earning of income (once as operating income and again as a dividend); the events are equivalent. In finding that the events were not equivalent, the California Court of Appeal erroneously focused on the taxpayer and not on the event. The California Court of Appeal ignored the fact that in both circumstances the taxable *event* is the same – the earning of income that is subject to California tax.

5. The California Dividends-Received Deduction Meets the Requirements of the Compensatory Tax Defense When It Is Correctly Applied.

The California deduction satisfies the three prongs of the compensatory tax defense. The "intrastate tax" for which section 24402 compensates is the potential burden of California double taxation of corporate income from which a dividend was paid. As described above, California taxes only its apportioned and allocated share of the income the first time in the hands of the dividend-paying corporation when it earns income attributable to California. Without section 24402, California would tax the California-sourced income a second time, in the hands of the dividend recipient, when a corporation pays a dividend from income previously taxed by California to a corporation taxable in California. California compensates for this intrastate burden by allowing a dividends-received deduction to the extent the dividend is paid from income previously apportioned to and taxed by California. The compensation is equally available to corporations operating wholly within California and those that operate within and without the State.

Section 24402 satisfies the second, "roughly approximates" prong. In this instance, the "tax on interstate commerce" is the denial of a deduction to California corporate taxpayers to the extent that they receive dividends paid from income that was not previously subject to California taxation. California is providing relief solely with respect to the event that it would otherwise tax twice, the earning of income attributable to California. Both events are subject to the same tax at the same rate. The resulting tax on dividends paid from income not previously

taxed by California equals the amount of tax paid on income used to pay the dividends for which the deduction is allowed. Examples 1 and 2 (*ante,* pp. 10-11) show this. In example 1, Corporation B benefits from the section 24402 deduction while Corporation D in example 2 does not. But the after-tax income of the recipient, Corporation B in example 1 and Corporation D in example 2, is the same, $91.16. Because the "tax on interstate commerce" equals the "tax on intrastate commerce" it necessarily follows that the "roughly approximates" requirement is satisfied.

The third prong of the test requires that the interstate and intrastate taxes be on substantially equivalent events. "Substantial equivalency" does not require exact equivalency.[21] The receipt of income, whether it be operating income or the dividends therefrom, is the taxable event. Here the events being compared are at least substantially equivalent, if not identical.

All requirements of the compensatory tax defense are met. Therefore the California dividends-received deduction does not unconstitutionally discriminate against interstate commerce for Commerce Clause purposes.

---

[21] See W. Hellerstein, *"Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination,"* 39 Tax Lawyer 405, 431 (1986) ("the formal equivalence of one tax to another cannot be a criterion of complementarity").

CONCLUSION

Review of the California Court of Appeal's decision through a writ of certiorari will provide needed clarity to the teaching of this Court's decisions and will provide necessary guidance to the States in determining whether actions intended to relieve burdens on intrastate commerce result in constitutionally impermissible discrimination against interstate commerce.

Respectfully submitted,

JOHN W. DAVIES, Chief Counsel
BENJAMIN F. MILLER, Counsel, Multistate Tax Affairs
(*Counsel of Record*)
KARL W. GROSSENBACHER, Sup. Tax Counsel
CRAIG A. SWIESO, Tax Counsel

Attorneys for Petitioner California Franchise Tax Board

November 2003

APPENDIX A

Filed 5/21/03

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

FARMER BROS. CO., Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.	B160061 (Los Angeles County Super. Ct. No. BC237663)

APPEAL from a judgment of the Superior Court of Los Angeles County. Gregory C. O'Brien, Jr., Judge. Affirmed.

Bill Lockyer, Attorney General, W. Dean Freeman, Lead Supervising Deputy Attorney General, and Gregory S. Price, Deputy Attorney General, for Defendant and Appellant.

Anglin, Flewelling, Rasmussen, Campbell & Trytten, Robin C. Campbell; Morrison & Foerster, Thomas Hugh Steele and Amy L. Silverstein for Plaintiff and Respondent.

In this case of first impression, we hold that Revenue and Taxation Code section 24402 (section 24402), known as the "dividends received deduction," violates the commerce clause of the United States Constitution (commerce

clause) by discriminating against corporations engaged in interstate commerce.[1] Section 24402 affords to a corporate taxpayer an income tax deduction for a portion of the dividends it receives from another corporation when the dividends are declared from income which was included in the payer corporation's measure of California franchise tax, alternative minimum tax, or corporation income tax.[2] In holding that section 24402 violates the commerce

---

[1] The commerce clause provides that "Congress shall have Power . . . [¶] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." (U.S. Const., art. 1, § 8, cl.3.)

[2] Before 2000, former section 24402 provided a deduction in computing taxable income for "[a] portion of the dividends received during the income year declared from income which has been included in the measure of the taxes imposed under Chapter 2 . . . [corporation franchise tax], Chapter 2.5 . . . [alternative minimum tax], or Chapter 3 . . . [corporation income tax] upon the taxpayer declaring the dividends." (Former § 24402, subd. (a).)

In 2000, the Legislature amended subdivision (a) of section 24402 by replacing the phrase "income year" with "taxable year." For calendar and fiscal years beginning after January 1, 2000, "income year" and "taxable year" have the same meaning. (See Historical and Statutory Notes, 62 West's Ann. Rev. & Tax. Code (2003 supp.) foll. § 24402, p. 241.)

Subdivision (b) of section 24402 limits the deduction described in subdivision (a) in the following manner: (1) if the taxpayer owns more than 50 percent of the stock of the dividend-paying corporation, the taxpayer may deduct 100 percent of the dividends; (2) if the taxpayer owns 20 percent or more of the stock of the dividend-paying corporation, the taxpayer may deduct 80 percent of the dividends; (3) if the taxpayer owns less than 20 percent of the stock of the taxpaying corporation, the taxpayer may deduct 70 percent of the dividends. (§ 24402, subd. (b)(1)-(3) & (c).)

Even though this case involves a former version or versions of section 24402 in effect from 1992 to 1998, we refer to former section 24402 as section 24402, for ease of reference.

clause, we follow *Ceridian Corp. v. Franchise Tax Bd.* (2000) 85 Cal.App.4th 875 (*Ceridian*), in which the First District held that California Revenue and Taxation Code section 24410, which governs taxation of insurance company dividends paid to major corporate stockholders, was unconstitutional under the commerce clause.

The Franchise Tax Board (FTB) appeals from a judgment awarding plaintiff Farmer Bros. Co. (Taxpayer) state tax refunds totaling $811,000 for the tax years 1992 through 1998, plus interest and costs, as a remedy for overpaying taxes under the provisions of section 24402, which statute the trial court determined to be unconstitutional under the commerce clause. We agree with the trial court's conclusion and affirm the judgment.

FACTUAL AND PROCEDURAL BACKGROUND

This case was submitted for determination by the trial court on a joint stipulation of facts and written trial briefs, which provide the undisputed factual background.

Taxpayer is a California corporation primarily engaged in the business of manufacturing and selling coffee and coffee-related products. For the years 1992 through 1998, Taxpayer timely filed California corporate income or franchise tax returns with the FTB. Each return reported a "dividends received deduction" under section 24402, representing a portion of the dividends Taxpayer had received during the income year. Taxpayer owned less than 20 percent of the stock in each of the payer corporations which had issued dividends to Taxpayer during the years at issue. Thus, for those dividends which qualify for the deduction under the terms of section 24402, subdivision (a), the statute affords Taxpayer a maximum

deduction of 70 percent of the amount of the dividend. (§ 24402, subd. (b); see fn. 2, *ante.*)

FTB had promulgated a schedule listing the corporations and the percentage of their dividends that were deductible under section 24402. The schedule was based on a formula which allowed for a sliding scale deduction so that the taxpayer was entitled to more of a deduction if more of the income of the payer corporation was subject to specified California corporate taxes. (See Cal. Code Regs., tit. 18, § 24402 (rule 24402).)

As explained in rule 24402, "Taxpayers are permitted a deduction under Section 24402, for dividends received which were declared from income included in the measure of tax of the declaring corporation under this part." Rule 24402 also provides three examples to illustrate the operation of the dividends received deduction. Example (1) states: "The A Corporation receives dividends from B Corporation, whose entire income is also subject to tax under this part and has no other earnings not taxable under this part. A is allowed a deduction for all such dividends received from B." (Rule 24402.) Example (2) states: "The A Corporation received dividends from B Corporation, which is not subject to tax in California. None of the dividends received from B are deductible." (*Ibid.*) Example (3) states: "The A Corporation receives dividends from B Corporation, whose income is subject to allocation because its activities are carried on within and without the State. B's allocation percentage is 50 percent. The percentage of the dividends received by A which are deductible is determined by formula. The variance from 50 percent will be affected by the extent of nonunitary and nontaxable income." (*Ibid.*)

The concept of a "unitary business" has been developed in cases addressing the problem of the local taxation of businesses operating in more than one jurisdiction. (See *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 164-166, [103 S.Ct. 2933, 2939-2941, 77 L.Ed.2d 545].) "California, like many other States, uses what is called a 'unitary business' income-calculation system for determining its taxable share of a multistate corporation's business income. . . . [¶] The income of which California taxes a percentage is constitutionally limited to a corporation's 'unitary' income. Unitary income normally includes all income from a corporation's business activities, but excludes income that 'derive[s] from unrelated business activity which constitutes a discrete business enterprise,' [citation]. As we have said, this latter 'nonunitary' income normally is not taxable by any State except the corporation's State of domicile (and the States in which the 'discrete enterprise' carries out its business)." (*Hunt-Wesson, Inc. v. Franchise Tax Bd.* (2000) 528 U.S. 458, 460-461, [120 S.Ct. 1022, 1024-1025, 145 L.Ed.2d 974].)

Pursuant to FTB's formula and schedule for dividends deductible under section 24402, some of the dividends received by Taxpayer from certain corporations in certain years were not deductible. For example, in 1998 Taxpayer received a dividend from Farmland Industries of about $11,000, but no part of the dividend was deductible, based on section 24402 and Farmland Industries's paying no California franchise tax in 1998. As to other corporations which paid dividends to Taxpayer, various portions of those dividends were subject to the section 24402 deduction. For example, in 1998, Taxpayer received a total dividend of about $4,800 from Merrill Lynch but only

1.839 percent of that dividend, or about $89, was deductible. As to a total dividend in 1992 of $17,550 from San Diego Gas & Electric, almost all of the dividend, or 99.546 percent, was deductible.

Taxpayer timely filed amended tax returns claiming a dividends received deduction for all dividends received for the years at issue and requested refunds totaling over $800,000, plus interest. Taxpayer asserted as the ground for the refunds that section 24402 violated the commerce clause of the United States Constitution. FTB denied Taxpayer's claims for refunds. Taxpayer appealed the denial to the State Board of Equalization (Board), which considered the appeal and sustained FTB's action on the ground that the Board "does not have the authority to deny the application of Revenue and Taxation Code section 24402 on constitutional grounds."

In September 2000, Taxpayer filed the instant action for refund of corporate franchise or income tax. In a first amended complaint, Taxpayer asserted that section 24402 is unconstitutional under the commerce clause of the United States Constitution because it discriminates on its face against interstate commerce by improperly taxing income that is not attributable to business transacted in California and the deduction cannot be justified as a lawful compensatory tax. FTB answered the first amended complaint in May 2001.

On the trial date, October 25, 2001, the parties filed opening trial briefs and a joint stipulation of facts and lodged interrogatories propounded by Taxpayer and FTB's responses. A witness list proffered by FTB indicated it intended to call as witnesses Professors Richard Pomp and Stephen Sheffrin regarding the issue of whether section

24402 violated the commerce clause. In response to FTB's witness list, Taxpayer filed a motion in limine to bar expert testimony on the constitutionality issue. The October 25, 2001 minute order indicates that the parties agreed to bifurcate the trial, with the court adjudicating first the issue of the constitutionality of section 24402 and then, if necessary, the issue of remedy. The court afforded the parties until November 8, 2001, to file responses to the opening briefs. With respect to the motion in limine, the minute order states that FTB would have until November 8, 2001, to file opposition and then "the cause will stand submitted. [¶] If the plaintiff's motion in-limine to bar expert testimony on the constitutionality issue is denied and expert testimony is to be taken, trial will be continued into early next year for that testimony."

In FTB's response to the motion in limine, FTB faulted Taxpayer for failing to obtain any discovery with respect to expert witnesses and instead, "on the day set for trial, Taxpayer file[d] a motion in which it presents to the Court Taxpayer's assumptions as to the nature of the testimony to be offered by the Board's witnesses and asks that they be barred from testifying because this assumed testimony is inadmissible. Taxpayer is not only tilting at windmills, it is doing so after constructing the very edifices at which it aims its lance." FTB then pointed out that expert opinion testimony properly could be offered as to factual issues arising under the compensatory tax doctrine defense but expressly refused to go into any greater detail as to any such testimony, thus refusing "to give Taxpayer the benefits . . . which it would have received had it exercised the diligence necessary to elicit and refine such information [through discovery]." According to FTB, "Taxpayer's remaining option is to wait until questions are

posed to the Board's independent expert witnesses and then interpose such objections as it deems appropriate."

On November 8, 2001, both parties filed responsive trial briefs. FTB's brief addressed the issue of the compensatory tax doctrine, but FTB did not offer any testimony or additional evidence as to that issue.

On November 21, 2001, the court issued its ruling on submitted matter, ruling in pertinent part: "It is agreed that to the extent that a dividend-paying corporation had a larger share of its sales, property and/or payroll in California, plaintiff was entitled under [section 24402] to deduct a larger percentage of the dividends it received – up to a maximum deduction of 70 percent. On the other hand, the section permits no tax deduction as to dividends generated from business outside of California. . . . [¶ FTB] maintains that because in-state corporations have already been subjected to franchise tax, the statutory goal is merely compensatory. It argues: 'The purpose of (the statute) is to prevent the imposition of a second tax upon the stream of income leading to the dividend (citations). California's only responsibility is to prevent . . . double taxation. . . . ' In effect, defendant argues that both the statute's intent and effect are non-discriminatory.

"This court disagrees. . . . It is a scheme . . . that facially places an unconstitutional burden on interstate commerce.

"Plaintiff's objection to the proffer of live testimony by [defendant's] expert is denied as moot."

At a January 29, 2002 further status conference, which was not reported, the court ordered that the issue of remedy was to be determined after the parties submitted

briefs on the issue. FTB thereafter filed a petition for an extraordinary writ, challenging, among other rulings, the ruling denying plaintiff's motion in limine as moot. In its writ petition, FTB argued that if the Court of Appeal "concludes that factual questions remain to be answered before this issue [whether section 24402 is a permitted compensatory tax] can be resolved, then due process requires that [FTB] be allowed to present the testimony of its named expert witnesses for that purpose." On March 7, 2002, we denied the petition for extraordinary writ. (*Franchise Tax Board v. Superior Court* (Mar. 7, 2002, B156702).)

After the parties submitted briefs on the issue of the appropriate remedy, the court determined that Taxpayer was entitled to recover refunds of corporate income and franchise taxes for the years 1992 to 1998 totaling $811,000, plus interest and costs. The judgment awarded Taxpayer a remedy consisting of the deduction set out in section 24402 for dividends received, as if the dividends were "declared from income which [had] been included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends." (§ 24402, subd. (a).) Judgment was entered on May 13, 2002. FTB filed a timely notice of appeal from the judgment.

FTB challenges only the finding that section 24402 is unconstitutional under the commerce clause, and not the finding that a tax refund is the proper remedy for the invalidity of section 24402. FTB does not challenge the remedy, and the parties do not discuss that issue, so neither do we. In other words, if we agree with the trial court's finding of unconstitutionality, then we may affirm the judgment without addressing the issue of remedy.

DISCUSSION

As the issue of the constitutionality of section 24402 under the commerce clause is presented on undisputed facts and is one of law, our review is de novo. (*Ghirardo v. Antonioli* (1994) 8 Cal.4th 791, 799-801; *State of Ohio v. Barron* (1997) 52 Cal.App.4th 62, 67 [constitutional issues are reviewed de novo].)

A. Section 24402 is Facially Discriminatory

"The Constitution gives Congress the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) 'Though phrased as a grant of regulatory power to Congress, the [Commerce] Clause has long been understood to have a "negative" aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce. [Citations.]' [Citation.]" (*Ceridian, supra,* 85 Cal.App.4th at p. 882.) This negative aspect of the commerce clause, also known as the dormant commerce clause (*Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, 331, [116 S.Ct. 848, 854, 133 L.Ed.2d 796] (*Fulton*)), prohibits economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors. (*Ceridian, supra,* 85 Cal.App.4th at p. 882.)

In evaluating state regulatory measures under the dormant commerce clause, the United States Supreme Court has held that the first step is to determine whether it regulates evenhandedly with only incidental effects on interstate commerce or discriminates against interstate commerce. (*Fulton, supra,* 516 U.S. at p. 331 [North Carolina's intangibles tax violated the dormant commerce clause].) With respect to state taxation, a state law is

treated as discriminatory if it taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state. (*Ibid.; Ceridian, supra,* 85 Cal.App.4th at p. 882.) "State laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.'" (*Fulton, supra,* 516 U.S. at p. 331.) A law that is discriminatory on its face must be invalidated unless the state can show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. (*Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 100-101 [114 S.Ct. 1345, 1351, 128 L.Ed.2d 13] (*Oregon Waste*) [Oregon's $2.25 per ton surcharge on disposal of out-of-state waste violated commerce clause in view of $0.85 per ton charge imposed on solid in-state waste].)

"[A] tax may violate the commerce clause even if it has no discriminatory goal or intent, if it is facially discriminatory, or has the *effect* of unduly burdening interstate commerce. [Citations.] 'Absent a compelling justification . . . a State may not advance its legitimate goals by means that facially discriminate against [interstate] commerce.'" (*Ceridian, supra,* 85 Cal.App.4th at p. 884.) "Our cases require that justifications for discriminatory restrictions on commerce pass the 'strictest scrutiny.' [Citation.] The State's burden of justification is so heavy that 'facial discrimination by itself may be a fatal defect.'" (*Oregon Waste, supra,* 511 U.S. at p. 101.)

We conclude that section 24402 is discriminatory on its face because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California.

As a result, the dividends received deduction scheme favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause. (*Armco Inc. v. Hardesty* (1984) 467 U.S. 638, 642 [104 S.Ct. 2620, 2622, 81 L.Ed.2d 540].) "That the tax discrimination comes in the form of a deprivation of a generally available tax benefit, rather than a specific penalty on the activity itself, is of no moment" under commerce clause jurisprudence. (*Camps Newfound/ Owatonna, Inc. v. Town of Harrison* (1997) 520 U.S. 564, 578-579 [117 S.Ct. 1590, 1599, 137 L.Ed.2d 852].)

"A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [in-state] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." (*Fulton, supra,* 516 U.S. at p. 333.) In *Fulton,* the court held invalid under the commerce clause North Carolina's "intangibles tax," which taxed "a fraction of the value of corporate stock owned by North Carolina residents inversely proportional to the corporation's exposure to the State's income tax." (*Id.* at p. 327.)

Like the sliding scale deduction at issue in this case, residents of North Carolina were "entitled to calculate their tax liability by taking a taxable percentage deduction equal to the fraction of the issuing corporation's income subject to tax in North Carolina." (*Fulton, supra,* 516 U.S. at p. 328.) "Thus, a corporation doing all of its business

within the State would pay corporate income tax on 100% of its income, and the taxable percentage deduction allowed to resident owners of that corporation's stock under the intangibles tax would likewise be 100%. Stock in a corporation doing no business in North Carolina, on the other hand, would be taxable on 100% of its value. For the intermediate cases, holders of stock were able to look up the taxable percentage for a large number of corporations as determined and published annually by the North Carolina Secretary of Revenue. . . . " (*Ibid.*) The *Fulton* court concluded that "[t]here is no doubt that the intangibles tax facially discriminates against interstate commerce," because such a tax "favors domestic corporations over their foreign competitors in raising capital," and tends "to discourage domestic corporations from plying their trades in interstate commerce." (*Id.* at p. 333.)

Ceridian applied the principles in *Fulton* to Revenue and Taxation Code section 24410, which "allows a deduction in computing taxable income ([Rev. & Tax. Code,] § 24401) for 'Dividends received by a corporation commercially domiciled in California . . . from an insurance company subject to tax imposed by [the "Insurance Taxation" part] of this division at the time of the payment of the dividends and at least 80 percent of each class of its stock then being owned by the corporation receiving the dividend.'" (*Ceridian, supra,* 85 Cal.App.4th at p. 881.) The *Ceridian* court concluded that "a statutory scheme, such as the one before us, that disallows a deduction based on the amount of *property and employees* that the dividend-declaring insurer has in another state, favors domestic corporations over their foreign competitors in raising capital among California corporations, and tends, at least, to discourage domestic corporations from plying their

trade in interstate commerce, from purchasing property or hiring employees in other states, and from purchasing subsidiary insurance corporations that do so. Thus, [Revenue and Taxation Code] section 24410, subdivision (b) is unquestionably discriminatory on its face." (*Ceridian, supra,* 85 Cal.App.4th at p. 887.)

"Just as North Carolina [in *Fulton, supra,* 516 U.S. 325,] reduced its intangibles tax in direct proportion to the amount of business the owned corporation did within the state's borders, so too California reduces the dividend tax to the extent such dividends are 'paid from income from California sources,' ([Rev. & Tax. Code,] § 24410, subd. (b)), which is calculated based on the proportionate amount of property, payroll and gross receipts the owned corporation has within California. *Fulton* prohibits such discriminatory treatment." (*Ceridian, supra,* 85 Cal.App.4th at p. 887.)

Because the dividends received deduction of section 24402 discriminates against corporations engaged in interstate commerce in the same fashion as does Revenue and Taxation Code section 24410, *Ceridian* provides persuasive authority to support our conclusion that section 24402 is discriminatory on its face. While FTB correctly points out that *Ceridian* did not address the same statute involved here, and that we are not bound by that opinion, FTB still offers no cogent reason why *Ceridian's* analysis is not convincing in resolving the commerce clause issue in this case.

We also reject FTB's claim that section 24402 does not violate the "internal consistency doctrine" in assessing whether a tax is discriminatory. "The internal consistency doctrine requires that the imposition of a tax identical to a

challenged tax in every state would add no burden to interstate commerce that intrastate commerce did not also bear, and looks at the structure of the challenged tax to see whether its identical application by every state would place interstate commerce at a disadvantage against intrastate commerce." (*D.D.I., Inc. v. State* (2003) 657 N.W.2d 228, 234 (*D.D.I.*) [similar dividends received deduction held unconstitutional under commerce clause and was not a valid compensatory tax].) Here, the imposition of the dividends received deduction by every state would favor intrastate commerce over interstate commerce by giving a greater tax benefit to taxpayers investing in their home state corporations as opposed to out-of-state corporations or corporations engaged in multistate business. Section 24402 violates the internal consistency doctrine.

B. FTB Fails to Justify Section 24402 as a Compensatory Tax

"[A] facially discriminatory tax may still survive Commerce Clause scrutiny if it is a truly '"compensatory tax" designed simply to make interstate commerce bear a burden already borne by intrastate commerce.'" (*Fulton, supra,* 516 U.S. at p. 331.) "Though our cases sometimes discuss the concept of the compensatory tax as if it were a doctrine unto itself, it is merely a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means. . . . Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative

Commerce Clause." (*Oregon Waste, supra,* 511 U.S. at p. 102.)

The cases have distilled three conditions, or prongs, necessary for a valid compensatory tax: (1) A state must, as a threshold matter, identify the intrastate tax burden for which the state is attempting to compensate, (2) the tax on interstate commerce must be shown roughly to approximate, but not exceed, the amount of the tax on intrastate commerce, and (3) the events on which the interstate and intrastate taxes are imposed must be substantially equivalent, that is, they must be sufficiently similar in substance to serve as mutually exclusive proxies for each other. (*Fulton, supra,* 516 U.S. at pp. 332-333.)

Addressing the first prong, as explained in *Oregon Waste,* "The prototypical example of substantially equivalent taxable events is the sale and use of articles of trade. [Citation.] In fact, use taxes on products purchased out of state are the only taxes we have upheld in recent memory under the compensatory tax doctrine." (*Oregon Waste, supra,* 511 U.S. at p. 105.)

FTB argues that "[t]he intrastate burden that section 24402 compensates for is the California tax burden on the income of the dividend payor, when that income is again included in the income of the corporate dividend recipient." Yet the United States Supreme Court in *Fulton,* citing *Oregon Waste,* warned "of the danger of treating general revenue measures as relevant intrastate burdens for purposes of the compensatory tax doctrine. '[P]ermitting discriminatory taxes on interstate commerce to compensate for charges purportedly included in general forms of intrastate taxation would allow a state to tax interstate commerce more heavily than in-state commerce

anytime the entities involved in interstate commerce happened to use facilities supported by general state tax funds.' [Citation.] We declined then [in *Oregon Waste*], as we do now, 'to open such an expansive loophole in our carefully confined compensatory tax jurisprudence.'" (*Fulton, supra,* 516 U.S. at p. 335.)

A "double taxation" argument similar to that made by FTB was rejected by the Supreme Court of North Dakota in *D.D.I., supra,* 657 N.W.2d 228, which involved a similar dividends received deduction. "Although avoiding double taxation of North Dakota income is a permissible goal, the Commissioner has not identified any specific in-state activity or benefit received by the taxpayers to justify the compensatory levy on their dividends received from out-of-state corporations. The State of North Dakota does not have a general sovereign interest in taxing income earned out-of-state and must identify some specific in-state activity or benefit to justify a compensatory levy. [Citation.] The Commissioner has failed to establish such an in-state benefit to the taxpayers." (*Id.* at p. 234.)

As pointed out by the court in *D.D.I.,* the double taxation argument also ignores the corporate income tax that an out-of-state corporation's state might impose. Thus, the dividends received deduction "does not avoid double taxation for out-of-state corporate income and does not roughly approximate the tax on intrastate commerce. . . ." (*D.D.I., supra,* 657 N.W.2d at p. 234.)

Based on the same reasoning set out in *Fulton* and *D.D.I.,* we conclude that FTB has failed to establish the first prong of the compensatory tax doctrine.

The second prong of the compensatory tax is that it must roughly approximate the amount of the tax on

intrastate commerce. The Supreme Court in *Oregon Waste* acknowledged the difficulty of satisfying this element when the state contends that the tax burden on interstate commerce compensates for the burden of state income taxes. Whether or not the interstate tax burden roughly approximates the intrastate tax burden "is difficult to determine, as '[general] tax payments are received for the general purposes of the [government], and are, upon proper receipt, lost in the general revenues.'" (*Oregon Waste, supra,* 511 U.S. at p. 104.)

In *Fulton,* the court discussed the theory that one of the services provided by the state of North Carolina, and supported through its general corporate income tax, is the maintenance of a capital market for corporations wishing to sell stock to state residents. The Secretary of Revenue of North Carolina argued that the state "may require those companies to pay for the privilege of access to the State's capital markets by a tax on the value of the shares sold." (*Fulton, supra,* 516 U.S. at p. 335.) The *Fulton* court found the argument unconvincing. "North Carolina, like most States, regulates access to its capital markets by means of blue sky laws, [citation], and their accompanying regulations, which prescribe who may sell securities in North Carolina, the procedures that must be followed to do so, and the fees imposed for the privilege. [Citations.] Absent probative evidence to the contrary, which the [State] has not supplied, we can reasonably assume that North Carolina has provided for the upkeep of its capital market through these provisions, not through the general corporate income tax. [¶] If the corporate income tax does not support the maintenance of North Carolina's capital market, then the State has not justified imposition of a

compensating levy on the ownership of shares in corporations not subject to the income tax." (*Id.* at p. 336, fn. omitted.)

As explained in *Fulton,* the corporate income tax "is a general form of taxation, not assessed according to the taxpayer's use of particular services, and before its revenues are earmarked for particular purposes they have been commingled with funds from other sources. As a result, the [State] cannot tell us what proportion of the corporate income tax goes to support the capital market, or whether that proportion represents a burden greater than the one imposed on interstate commerce by the intangibles tax. . . . [¶] . . . Where general forms of taxation are involved, we ordinarily cannot even begin to make the sorts of qualitative assessments that the compensatory tax doctrine requires." (*Fulton, supra,* 516 U.S. at p. 338.)

The court in *Fulton* acknowledged that "[w]hile we need not hold that a State may never justify a compensatory tax by an intrastate burden included in a general form of taxation, the linkage in this case between the intrastate burden and the benefit shared by out-of-staters is far too tenuous to overcome the risk posed by recognizing a general levy as a complementary twin." (*Fulton, supra,* 516 U.S. at p. 336.) Thus, while it may not have been "inconceivable, however unlikely, that a capital markets component of the corporate income tax exceeds the intangibles tax in magnitude," the court in *Fulton* concluded that the state had not met its burden of demonstrating the second prong of the compensatory tax doctrine. (*Id.* at p. 338.)

As in *Fulton,* FTB also has not met its burden of demonstrating the second prong of the compensatory tax doctrine.

The third prong of the compensatory tax doctrine requires that the compensating taxes fall on substantially equivalent events. FTB argues that this condition is met because corporate income and the dividend paid from that income are the "same dollars" and are substantially similar events. Yet, *Fulton* expressly disapproved of this analysis with respect to the intangibles tax. "[W]e find that the intangibles tax is not functionally equivalent to the corporate income tax." (*Fulton, supra,* 516 U.S. at p. 339.) Because the objective of the equivalent-event requirement is to enable in-state and out-of-state businesses to compete on an equal footing, "[t]his equality of treatment does not appear when the allegedly compensating taxes fall respectively on taxpayers who are differently described, as, for example, resident shareholders and corporations doing business out of state. A State defending such a tax scheme as one of complementary taxation, therefore, has the burden of showing that the actual incidences of the two tax burdens are different enough from their nominal incidences so that the real taxpayers are within the same class, and that therefore a finding of combined neutrality on interstate competition would at least be possible." (*Id.* at p. 340.)

The court in *Fulton* noted that determining whether the tax burden is shifted out of state, rather than borne by in-state producers and consumers, requires complex factual inquiries, and that courts as institutions are poorly equipped to evaluate with precision the relative burdens of various methods of taxation. (*Fulton, supra,* 516 U.S. at pp. 341-342.) "Indeed, the general difficulty of comparing

the economic incidence of state taxes paid by different taxpayers upon different transactions goes a long way toward explaining why we have so seldom recognized a valid compensatory tax outside the context of sales and use taxes." (*Id.* at p. 342.)

Thus, under the third prong of the compensatory tax doctrine, FTB must establish that the burden created by the structure of the dividends received deduction falls on the same class of taxpayers as does the corporate income tax. Yet the burden of section 24402 is on the taxpayer receiving dividends, while the burden of the corporate income tax is on the payer corporation. FTB has failed to offer any factual or logical support for its claim that the actual incidences of these two taxes are imposed upon the same class of taxpayers (see *Fulton, supra,* 516 U.S. at p. 340, fn. 6) or that the dividends received deduction amounts to a clear equivalent for the corporate income tax. As stated by the court in *Fulton,* "there are reasons to doubt the [State's] contention that the corporate income tax amounts to a clear equivalent for the burden on shareholding imposed by the intangibles tax." (*Id.* at p. 344.) Because the doubts expressed in *Fulton* also arise here, we conclude that FTB fails to establish the third prong of the compensatory tax doctrine.

As FTB fails to justify section 24402 as a compensatory tax, and it impermissibly discriminates against interstate commerce, the statute violates the commerce clause.

C. Expert Witness Testimony

FTB contends that the trial court erroneously denied it the opportunity to present expert testimony relating to

the compensatory tax doctrine. FTB fails to show that it ever proffered or sought to introduce any such testimony, that it made an offer of proof, or that the trial court made any ruling on the matter. In other words, there is simply no ruling for us to review. A party on appeal cannot successfully complain because the trial court failed to do something which it was not asked to do. (*Chyten v. Lawrence & Howell Investments* (1994) 23 Cal.App.4th 607, 617.)

DISPOSITION

The judgment is affirmed.

CERTIFIED FOR PUBLICATION.

MALLANO, J.

We concur:

ORTEGA, Acting P.J.

VOGEL (MIRIAM A.), J.

APPENDIX B

Robin C. Campbell (#070374)
ANGLIN, FLEWELLING, RASMUSSEN,
CAMPBELL & TRYTTEN LLP
199 South Los Robles Avenue, Suite 600
Pasadena, California 91101
Telephone: (626) 535-1900
Facsimile: (626) 577-7764

Thomas H. Steele (#72799)
Amy L. Silverstein (#154221)
MORRISON & FOERSTER LLP
425 Market Street
San Francisco, California 94105-2482
Telephone: (415) 268-7000
Facsimile: (415) 268-7522

Attorneys for Plaintiff
FARMER BROS. CO.

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF LOS ANGELES

FARMER BROS. CO., a California corporation, Plaintiff, vs. FRANCHISE TAX BOARD, Defendant.	Case No.: BC237663 [~~AMENDED PROPOSED~~] JUDGMENT Judge: Hon. Gregory O'Brien (Filed May 13, 2002)

This action came on regularly for trial on October 25, 2001 and subsequent dates in Department 21 of the above-entitled Court, the Honorable Gregory O'Brien, presiding. Robin C. Campbell of Anglin, Flewelling, Rasmussen, Campbell & Trytten LLP appeared as the attorneys for

plaintiff Farmer Bros. Co., and Herbert A. Levin and Gregory Price, Deputy Attorneys General of the State of California, appeared as attorneys for defendant Franchise Tax Board.

The Court heard and considered evidence, including the stipulation of facts and supplemental stipulation of facts submitted by the parties, and the written arguments of counsel. The matter having been submitted for decision,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. That plaintiff Farmer Bros. Co. recover from defendant Franchise Tax Board a money judgment for $811,000.00, consisting of refunds of corporate income and franchise taxes for the following years in the following amounts:

a. $79,000 for income year 1992;
b. $79,000 for income year 1993;
c. $77,000 for income year 1994;
d. $137,000 for income year 1995;
e. $144,000 for income year 1996;
f. $150,000 for income year 1997; and
g. $145,000 for income year 1998.

2. That plaintiff Farmer Bros. Co. recover $563,738 in interest through April 30, 2002, plus additional interest thereafter as provided under Revenue and Taxation Code section 19391.

3. That plaintiff Farmer Bros. Co. recover its costs of litigation, as provided under Revenue and Taxation Code section 19717, consisting of $___ in reasonable court costs, $___ in reasonable expenses of expert witnesses, and $___ in reasonable attorneys' fees.

Dated: May 13, 2002

GREGORY G. O'BRIEN
Hon. Gregory O'Brien
Judge of the Superior Court

APPENDIX C

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

FRANCHISE TAX BOARD, Petitioner, v. THE SUPERIOR COURT OF LOS ANGELES COUNTY, Respondent; FARMER BROS., CO., Real Party in Interest.	B156702 (L.A.S.C. No. BC237663) (GREGORY O'BRIEN, Judge) ORDER (Filed Mar. 7, 2002)

THE COURT*:

The petition for writ of mandate/prohibition, filed February 26, 2002; and the preliminary opposition thereto, filed March 4, 2002, have been read and considered.

The petition is denied.

---

* ORTEGA, Acting P.J.

VOGEL (MIRIAM A.), J.

MALLANO, J.

APPENDIX D

Court of Appeal, Second Appellate District, Division One – No. B160061

S117131

IN THE SUPREME COURT OF CALIFORNIA

En Banc

FARMERS BROTHERS COMPANY,
Plaintiff and Respondent,

v.

FRANCHISE TAX BOARD, Defendant and Appellant.

(Filed Aug. 27, 2003)

Request for judicial notice GRANTED.
Petition for review DENIED.

Werdegar, J., was absent and did not participate.

/s/ George
Chief Justice

APPENDIX E

SUPERIOR COURT OF CALIFORNIA, COUNTY OF LOS ANGELES

DATE: 11/21/01 HONORABLE Gregory O'Brien HONORABLE 10 NONE	JUDGE JUDGE PRO TEM Deputy Sheriff
S. SMYTHE NONE	**DEPT. 21** DEPUTY CLERK ELECTRONIC RECORDING MONITOR Reporter
BC237663 FARMER BROS CO VS. FRANCHISE TAX BOARD	Plaintiff Counsel [NO APPEARANCES] Defendant Counsel

NATURE OF PROCEEDINGS:

RULING ON SUBMITTED MATTER

The matter before the court was submitted on briefs, including a joint stipulation as to the facts.

Plaintiff California coffee manufacturer is a shareholder of various companies engaged in interstate commerce. Plaintiff seeks a partial refund of taxes collected for the income years 1992 through 1998. The disputed taxes were levied upon certain of plaintiff's shareholder dividends declared by these companies.

It is agreed that to the extent that a dividend-paying corporation had a larger share of its sales, property and/or payroll in California, plaintiff was entitled under Revenue

& Tax Code Section 24402 to deduct a larger percentage of the dividends it received – up to a maximum deduction of 70 percent. On the other hand, the section permits no tax deduction as to dividends generated from business outside of California. Plaintiff challenges the constitutionality of Section 24402 on the basis that it imposes an impermissible burden on interstate commerce. Plaintiff urges that the court follow the reasoning of, among other cases, CERIDIAN CORPORATION v. FRANCHISE TAX BOARD (2000) 85 Cal.App.4th 875, which recently struck down similar provisions of Revenue & Tax Code Section 24410 on constitutional grounds. Plaintiff has exhausted its administrative remedies.

Defendant tax board maintains that because in-state corporations have already been subjected to franchise tax, the statutory goal is merely compensatory. It argues: "The purpose of (the statute) is to prevent the imposition of a second tax upon the stream of income leading to the dividend (citations). California's only responsibility is to prevent . . . double taxation. . . ." In effect, defendant argues that both the statute's intent and effect are non-discriminatory.

This court disagrees. Shareholders are the owners of a business. Dividends are declared earnings remitted to owners on a per-share basis. A tax on dividends properly is a tax upon an owner's income, not a tax on the "stream of income leading to the dividend." Therefore, what is really being "compensated" is the state's initial inability to impose a franchise tax on foreign corporations. By the device of giving harsher tax treatment to dividends from out-of-state businesses, California has managed to accomplish by indirection what it cannot do by direction, namely, it effectively has levied an in-lieu tax based upon corporate

income streams occurring beyond its borders. By subjecting shareholders of foreign corporations to different treatment, the State says, in effect, "since we can't impose a franchise tax on your business at the front end, we'll tax you personally in an equivalent sum at the back end." It is a scheme too clever by half, and one that facially places [an] unconstitutional burden on interstate commerce.

Defendant's objection to the proffer of live testimony by plaintiff's expert is denied as moot.

Plaintiff shall prepare a judgment consistent with this ruling.

Copies of this minute order are sent to the following counsel via U.S. Mail, addressed as follows:

Walker, Wright, Tyler & Ward
Attn.: Robin C. Campbell, Esq.
626 Wilshire Blvd., #900
Los Angeles, Calif. 90017-3209

Herbert A. Levin, Esq.
Dep. Atty. Gen.
300 S. Spring St., #5212
Los Angeles, Calif. 90013-1204

APPENDIX F

CALIFORNIA CODES
REVENUE AND TAXATION CODE
SECTION 24271

24271. (a) Section 61 of the Internal Revenue Code, relating to gross income defined, shall apply, except as otherwise provided.

(b) A distributive share of partnership gross income shall be determined in accordance with Part 10 (commencing with Section 17001).

(c) Income from an interest in an estate or trust shall be determined in accordance with Part 10 (commencing with Section 17001).

24401. In addition to the deductions provided in Article 1 (commencing with Section 24341), there shall be allowed as deductions in computing taxable income the items specified in this article.

24402. (a) A portion of the dividends received during the taxable year declared from income which as been included in the measure of the taxes imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501) upon the taxpayer declaring the dividends.

(b) The portion of the dividends which may be deducted under this section shall be as follows:

(1) In the case of any dividend described in subdivision (a), received from a "more than 50 percent owned corporation," 100 percent.

(2) In the case of any dividend described in subdivision (a), received from a "20 percent owned corporation," 80 percent.

(3) In the case of any dividend described in subdivision (a), received from a corporation that is less than 20 percent owned, 70 percent.

(c) For purposes of this section:

(1) The term "more than 50 percent owned corporation" means any corporation if more than 50 percent of the stock of that corporation (by vote and value) is owned by the taxpayer. For purposes of the preceding sentence, stock described in Section 1504(a) (4) of the Internal Revenue Code shall not be taken into account.

(2) The term "20 percent owned corporation" means any corporation if 20 percent or more of the stock of that corporation (by vote and value) is owned by the taxpayer. For purposes of the preceding sentence, stock described in Section 1504(a) (4) of the Internal Revenue Code shall not be taken into account.

(d)(1) No deduction shall be allowed under this section in respect of any dividend on any share of stock:

(A) which is held by the taxpayer for 45 days or less during the 90-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend with respect to that dividend, or

(B) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(2) In the case of stock having preference in dividends, if the taxpayer receives dividends with respect to that stock which are attributable to a period or periods aggregating in excess of 366 days, subparagraph (A) of paragraph (1) shall be applied as follows:

(A) By substituting "90 days" for "45 days" in each place it appears.

(B) By substituting "180-day period" for "90-day period."

(3) For purposes of this subdivision, in determining the period for which the taxpayer has held any share of stock:

(A) the day of disposition, but not the day of acquisition, shall be taken into account, and

(B) Section 1223(4) of the Internal Revenue Code shall not apply.

(4) Section 246(c) (4) of the Internal Revenue Code, relating to the holding period reduced for periods where risk of loss diminished, shall apply, except as otherwise provided.

(e)(1) The amendments made by the act adding this subdivision shall apply to dividends received or accrued after the 30th day after the date of the enactment of the act adding this subdivision.

(2) The amendments made by the act adding this subdivision shall not apply to dividends received or accrued during the two-year period beginning on the date of the enactment of the act adding this subdivision if:

(A) the dividend is paid with respect to stock held by the taxpayer on January 1, 1998 and all times thereafter until the dividend is received,

(B) that stock is continuously subject to a position described in Section 246(c) (4) of the Internal Revenue Code on January 1, 1998, and all times thereafter until the dividend is received, and

(C) that stock and position are clearly identified in the taxpayer's records within 30 days after the date of the enactment of the act adding this subdivision.

(3) Stock shall not be treated as meeting the requirement of subparagraph (B) of paragraph (2) if the position is sold, closed, or otherwise terminated and reestablished.